

CUTTING IT

WHEN IT COMES TO ‘CUTTING’ THE NAV, WOULD YOUR FUND OVERSIGHT CUT IT WITH REGULATORS? MILESTONE’S **ROBERT PROCTOR** CONSIDERS HOW BEST PRACTICE IS EVOLVING.



WITHIN THE INVESTMENT

management sector, outsourcing of fund operations is now a well-established practice. Traditional operating models incorporating outsourcing were designed to achieve cost reductions, access perceived centres of excellence and avoid direct technology investment. Motivations have since evolved to include consideration of what are core and non-core activities and a desire to avoid refurbishing internal operating models and associated technology, sometimes at an increased cost.

Whatever the motivation, accessing fund operations capabilities via third parties can be effectively incorporated

into a valid operating model. However, this adds a different dimension of complexity and risk within a firm’s operations, prompting regulators to publish guidelines to assist in ensuring that risk to the overall market and individual investors is minimised.

The pervasive nature and scale of outsourcing and concentration of services into a finite number of large providers is causing an increased level of attention from regulators. The objective is to understand and mitigate upward pressure on systemic risk as the industry becomes less operationally distributed and more reliant on a relatively small number of larger players.

Within the increasingly prescriptive

and demanding funds regulatory landscape, one of the areas targeted for greater scrutiny by regulators has been around the due diligence and ongoing monitoring of delegated core activities such as the outsourced valuation of a fund’s net asset value (NAV).

Regulators continue to enforce the view that the responsible entity is accountable for ensuring NAV accuracy, independent of whether they appoint an external party to calculate the NAV or do so themselves. They are also exerting pressure on the market to have a back-up or contingent NAV should the outsourcer have an outage and be unable to produce a NAV over one or more days. These pressures are part of an overarching industry view reflected by regulators, and increasingly representing global industry best practice. The recent CSSF 18/698 circular notes that operational

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practices have evolved without global cohesiveness including, amongst other things, consistent data frameworks and make-up, and operational oversight team processes. There is increasing momentum within the regulatory sphere to ensure that the industry achieves higher operational resilience, meaning the ability to demonstrate the effective monitoring and deep understanding of those outsourced operational activities.

Regulated entities

Recognition that regulation and better oversight of the industry is a theme that will continue to develop in order to maintain a healthy and safe market infrastructure. Regulators have included resilience and oversight as key areas that must be addressed in terms of risk reduction and appropriate controls for the funds industry, two of the key risk areas particularly relevant to any outsourced arrangement. Regulators are guiding firms on the frequency, scope and nature of their oversight controls which must be appropriate to the level of risk associated with the delegation of each activity. For example, fund boards must demonstrate their ability to monitor service providers' key performance indicators (KPIs), plus maintain an appropriate level of independence where service provider KPIs may be insufficient. Boards must be able to evidence that adequate controls are in place to support ongoing monitoring, including thorough record-keeping and follow-up procedures supporting issue management.

These new and existing regulations represent an added challenge for responsible entities in demonstrating both effective oversight and contingency plans in the event of a service provider outage. The key observation is that oversight is now recognised as a true operational discipline that should be subject to the same tests of accuracy,

timeliness, reliability and auditability as any other mission-critical process. Practically, this translates to needing an oversight function that is independent of the service provider with robust controls and intraday validation of data, rather than an end-of-day regime. This realisation is an operational reality check for firms causing them to look again at their operational processes and technology employed. Spreadsheets and ad hoc tools are rapidly falling from favour and can actually increase operational risk as they typically lack transparency, speed, and effective change control needed in rigorous operational processes such as oversight. It is important that oversight professionals have access to tools that can not only assist an efficient oversight process, but also expedite diagnosis of any issues, allowing them to get ahead of an incorrect NAV causing downstream remediation costs and client impact.

The way forward

An easier way to achieve best practice and avoid falling foul of regulators is to implement a pre-fabricated technology solution that is precision-engineered to understand and streamline your oversight and contingent NAV processes, connecting with your third-party providers in an industry-standard infrastructure to enable access to best practice outcomes for responsible entities and their investors. This approach can provide a proven pathway to successfully minimise the risk of possible fines or penalties, as well as potential reputational damage and remediation costs. Consideration should be given to a professional-grade alternative to manual desktop tools and cumbersome, potentially

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costly shadow NAV solutions. The solution should span the end-to-end oversight process, including independent data management, market-standard validations, an integrated back-up NAV capability and operate independently of service provider infrastructure and processes. When it comes to insuring against a service provider outage, it becomes imperative that a contingent NAV capability should be fully independent including data sources.

While this remains a fast-moving area of focus, it may be beneficial to become part of a 'community' of like-minded organisations to share and leverage learnings from their oversight and contingent NAV journey through shared experience.

